

TABLE 1. (Continued)

Function and Subfunction	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
800 GENERAL GOVERNMENT										
806 <u>Other General Government</u>										
Credits for political contributions	40	60	80	100	100	80	80	80	100	80
850 GENERAL PURPOSE FISCAL ASSISTANCE										
851 <u>General Revenue Sharing</u>										
Exclusion of interest on general purpose state and local debt	4,785	5,395	5,365	5,880	5,930	6,480	7,305	7,980	8,560	9,045
Deductibility of non-business business state and local taxes (other than on owner-occupied homes)	8,095	8,505	10,935	14,665	18,405	23,060	28,060	33,670	40,405	48,485
852 <u>Other General Purpose Fiscal Assistance</u>										
Tax credit for corporations receiving income from doing business in United States possessions	285	485	685	780	1,005	1,095	1,200	1,320	1,455	1,600
Exclusion of income earned by individuals in United States possessions	---	---	---	---	---	---	---	---	---	---
900 INTEREST										
901 <u>Interest on the Public Debt</u>										
Deferral of interest on savings bonds	565	625	615	290	-75	335	335	335	335	335

(Continued)

TABLE 1. (Continued)

Function and Subfunction	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
TOTAL										
Revenue Losses	36,550	44,140	46,635	43,945	51,710	59,810	65,370	82,015	92,855	97,365
Number of Items	50	51	52	53	55	59	59	71	78	80

(Continued)

TABLE 1. (Continued)

Function and Subfunction	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
TOTAL										
Revenue Losses	113,455	123,470	149,815	181,480	228,620	266,280	306,435	350,530	403,725	465,290
Number of Items	85	84	92	92	104	104	103	103	100	98

SOURCES: Estimates of Federal Tax Expenditures, prepared by the Staffs of the Treasury Department and Joint Committee on Taxation (June 1, 1973, July 8, 1975, March 15, 1976, March 15, 1977, March 14, 1978, March 15, 1979, March 6, 1980, March 16, 1981); and Tax Analysts and Advocates, Tax Notes (April 15, 1974).

NOTE: The estimates were prepared only on a calendar year basis until 1973. The estimates for calendar years 1967 to 1973 correspond roughly to fiscal years 1968 to 1974.

- a. All estimates are based on the tax law in effect at the time the estimates were made. Individual and corporate tax expenditures for each year are combined.
- b. Less than \$2.5 million.
- c. Includes capital gains from iron ore for years 1967 to 1977.
- d. Included with capital gains from coal for years 1967 to 1977.
- e. Includes charitable contributions for health for years 1967 to 1974.
- f. Included with other charitable contributions for years 1967 to 1974.
- g. Dependents and survivors benefits, additional exemption for the elderly and the tax credit for the elderly included with OASI benefits for retired workers for years 1967 to 1973.
- h. The figures in the table indicate the effect of the earned income credit on receipts. The effect on outlays is \$1,165 million in 1976, \$1,015 million in 1977; \$945 million in 1978; \$840 million in 1979; \$1,695 million in 1980; \$1,205 million in 1981; \$1,115 million in 1982; \$1,030 million in 1983; \$955 million in 1984; \$855 million in 1985; and \$815 million in 1986.
- i. Includes veterans' pensions and exclusion of GI bill benefits for years 1967 to 1973.

TABLE 2. CHANGES IN THE TAX EXPENDITURE BUDGET, FISCAL YEARS 1967 TO 1986

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
Total Number of Tax Expenditures	50	51	52	53	55	59	59	71	78	80
Number Added Because Of										
Definitional Changes										
Items previously in the tax code but not included in the budget								11	4	
Subdivision of items previously in the budget		1						1	3	
Legislative Action			1	1	2	4		1	1	2
Number Subtracted Because Of										
Definitional Changes										
Items still in the tax code but no longer included in the budget								1		
Combination of previously separate items										
Legislative Action									1	

(Continued)

TABLE 2. (Continued)

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Total Number of Tax Expenditures	85	84	92	92	104	104	103	103	100	98
Number Added Because Of										
Definitional Changes										
Items previously in the tax code but not included in the budget			1							
Subdivision of items previously in the budget		1	1	1	10					
Legislative Action	5	1	6		5					
Number Subtracted Because Of										
Definitional Changes										
Items still in the tax code but no longer included in the budget					2					
Combination of previously separate items										
Legislative Action		3		1	1		1		3	2

SOURCE: Table 1.

earlier years are not formally revised to reflect these changes, except for the most recent year or two in which the old and new estimates overlap.

Changes in Other Tax Provisions. Estimates of tax expenditures may change when tax rates or other basic structural features of the tax code are changed, even if there are no explicit modifications in the tax expenditure provisions themselves. If tax rates are reduced across the board, for example, the measured revenue loss from tax expenditures will also be reduced, since special deductions and exclusions will be measured against lower rates.<sup>4</sup> Similarly, increases in the standard deduction (zero bracket amount) will reduce the revenue loss from tax expenditures that take the form of itemized deductions.

#### OUTLAY EQUIVALENTS

In order to make precise comparisons between tax expenditures and direct outlays programs for program analysis purposes, some adjustments in the tax expenditure estimates can be useful. If the government is trying to decide between a tax expenditure and a direct outlay subsidy program, for example, it may want to look at alternatives that provide the same after-tax benefits to recipients. The purpose of most subsidies is to influence behavior, and for this purpose the net amount of the subsidy after taxes is usually most important. But if the subsidy is taxable in one form but not in the other, the subsidies are not equivalent. The taxable subsidy is less valuable to the recipient because some portion of it is returned to the government in taxes, while its net cost to the government is less for the same reason.

The 10 percent investment tax credit, for example, is worth more to businesses than a taxable direct grant of the same amount would be, since businesses do not have to pay any tax on the amount of the credit. Accordingly, if the government were to substitute a taxable direct grant program for the investment tax credit, and wanted to keep the after-tax benefit to the recipients the same,

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4. There may also be a separate behavioral response from changes in tax rates, since the incentive for taxpayers to use special deductions or exclusions is reduced if they are worth less in tax savings. This effect may or may not be explicitly taken into account in the estimates, depending on how reliably the behavioral response can be estimated.

the total outlay cost--the "outlay equivalent"--would have to be larger than the revenue loss from the investment tax credit to cover the tax on the grant.

Some tax subsidies are, in effect, taxable. Businesses that use the targeted jobs tax credit, for example, must subtract the amount of the credit from the deduction for wages they would otherwise be allowed for tax purposes. This "basis adjustment" is equivalent to including the amount of the credit in income and

TABLE 3. HOUSING AND ENERGY TAX EXPENDITURES AND OUTLAY EQUIVALENTS, FISCAL YEARS 1980-1982 (In millions of dollars)

	1980	1981	1982
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Housing			
Owner-occupied housing			
Tax expenditures	25,335	31,565	39,725
Outlay equivalents	26,840	33,170	41,655
Rental Housing			
Tax expenditures	890	1,030	1,195
Outlay equivalents	1,965	2,155	2,410
Total			
Tax expenditures	26,225	32,595	40,920
Outlay equivalents	28,805	35,325	44,065
 Energy			
Conservation <sup>a</sup>			
Tax expenditures	660	785	850
Outlay equivalents	720	825	895
Supply <sup>b</sup>			
Tax expenditures	4,500	6,020	6,635
Outlay equivalents	7,715	9,520	10,875
Total			
Tax expenditures	5,160	6,805	7,485
Outlay equivalents	8,435	10,345	11,770
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a. Includes exemption from excise tax for buses and bus parts.

b. Includes exemption from excise tax for alcohol fuels.

subjecting it to tax. The cost in outlays of an equivalent taxable direct grant program would thus be the same as the revenue loss from the credit, with no extra amount for the tax.

Special Analysis G in the fiscal year 1982 budget contains a more systematic illustration of this approach. In a section prepared by the Treasury Department, the outlay equivalents of the tax expenditures for energy and housing are estimated, and then compared with direct budget outlays for those purposes.<sup>5</sup> As indicated in Table 3, which has been adapted from information in Special Analysis G, the outlay equivalents of tax expenditures are significantly higher than the tax expenditures themselves. Since the tax expenditure subsidies are tax free, an equivalent outlay would usually have to be higher to be worth the same amount to the recipient, and the budget cost of the equivalent outlay would also be higher.

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5. Budget of the United States Government, Fiscal Year 1982, Special Analyses, pp. 234-38 (January 1981).



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### CHAPTER III. TAX EXPENDITURE SUBSIDIES, GENERAL TAX CUTS, AND DIRECT EXPENDITURE SUBSIDIES

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Tax expenditure subsidies can be viewed as alternatives or supplements to federal spending, loan, or regulatory programs with similar goals. The targeted jobs tax credit, for example, is aimed in large measure at providing jobs for hard-core unemployed youths, a goal shared by the Job Corps program and the proposed subminimum wage for teenagers. There are tax credits, grants, and loans for residential energy conservation. Both the Export-Import Bank and the Domestic International Sales Corporation (DISC) tax provisions subsidize U.S. exports.

But tax expenditures can also be viewed as alternatives to more general tax cuts. Whenever the Congress faces a decision on cutting taxes, it has a choice between general across-the-board cuts--reductions in rates, bracket widening, increases in the zero bracket amount (standard deduction), increases in personal exemptions, and the like--and more narrowly targeted cuts that frequently take the form of tax expenditures.

This chapter reviews some of the considerations that may be relevant in choosing between tax expenditures and general tax cuts, and between tax expenditures and other forms of federal subsidies.

#### TAX EXPENDITURES AND GENERAL TAX CUTS

The effects of tax expenditures are very similar to those of federal spending and loan programs, so it is useful analytically to consider tax expenditures as alternatives to spending programs. In terms of actual legislative decisions, however, changes in tax expenditures are normally considered in the context of tax legislation rather than spending legislation, since committee jurisdictional problems can make it difficult to work out direct trade-offs between tax and spending programs. The choice is thus frequently between tax expenditures and more general tax cuts. Whenever the Congress is considering a large tax cut, for example, it must determine how much of the tax cut to devote to relatively broad

general cuts and how much to devote to new or expanded tax expenditure provisions. If repeal or reduction of existing tax expenditures is being considered, one possible use of the additional revenue would be to return it to taxpayers in the form of an across-the-board tax cut.

The choice between general tax cuts and tax expenditures has been on the Congressional agenda frequently during the past decade. Because of the interaction of inflation with the graduated rate structure of the individual income tax, regular tax cuts have been necessary to hold taxes relatively constant as a percentage of personal income. Starting with the Tax Reform Act of 1969, large personal and business tax cuts were approved in 1971, 1975, 1976, 1977, 1978, and 1981. The Economic Recovery Tax Act of 1981 may signal a significant break in that pattern, however. The act provides for an across-the-board reduction in individual income tax rates of 23 percent over the 1981 to 1984 period, followed by indexing of the individual income tax for inflation starting in 1985. In addition, the act provides for very large reductions in business taxes over the next five years, as more generous business depreciation allowances are phased in.

The Congress has thus chosen to provide large general tax cuts, but it has not yet fully determined how those cuts are to be financed. The 1981 tax act will reduce taxes by an estimated \$268 billion below the level they would otherwise have reached in fiscal year 1986, well in excess of the spending reductions that have been enacted thus far. Further reductions in spending will, therefore, be necessary if the goal of a balanced budget is to be reached by fiscal year 1984. Reductions in tax expenditures could also be used to fill this gap. Instead of simultaneous conversion of tax expenditure reductions into general tax cuts, the tax expenditure reductions could be used to finance the future-year tax cuts that have already been enacted.

Additionally, tax expenditure reductions could be used to fund still further reductions in general tax rates. The individual tax cuts enacted in 1981 actually do little more than hold the tax burden constant over the next few years, offsetting the tax increases that would otherwise have occurred because of inflation-induced increases in the individual income tax and scheduled increases in Social Security taxes.

It is, therefore, worth noting some of the considerations that arise in choosing between tax expenditures and general tax cuts.

In general terms, the choice is between relatively small per-taxpayer savings for large numbers of taxpayers and larger per-taxpayer savings for a more narrowly defined group of taxpayers. More specifically, however, the choice may turn on the possible effects of different alternatives on taxpayer behavior and on marginal tax rates.

#### Effects on Taxpayer Behavior

Because general across-the-board tax cuts usually involve small per-taxpayer savings, and, because the cuts do not specifically attempt to change taxpayer behavior, they normally do not alter taxpayer behavior in measurable ways. If the cuts include reductions in marginal tax rates, however, incentives to save, work, and invest may increase, leading to important changes in behavior. This is especially true for the highest marginal rates, such as the former top marginal rate of 70 percent on investment income, and the high rates that apply to low-income workers because of the phase-out of the earned income credit as income rises.<sup>1</sup>

Proponents of incentive-type tax expenditures usually argue that the targeted tax provisions that they propose will have greater effects on taxpayer behavior than broad across-the-board tax cuts. Those who advocate excluding a certain amount of interest income from tax, for example, suggest that this would do more to encourage increased saving than a cut in marginal tax rates with the same revenue loss. Opponents argue that most targeted savings incentives simply shift existing savings into the tax-favored forms without increasing overall net saving.

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1. The earned income credit is equal to 10 percent of the first \$5,000 of income, but it gradually phases down as income exceeds \$6,000, declining to zero for families with incomes over \$10,000. Thus, for each \$100 of extra income that a family earns above \$6,000, the earned income credit declines by \$12.50. This is equivalent to a marginal tax rate of 12.5 percent. When added to the marginal tax rates that result from the regular tax schedule, payroll taxes, and the phaseout of income-tested benefits from AFDC, food stamps, housing assistance, and the like, the cumulative marginal tax rates for such families can be well above 50 percent.

Generally, tax subsidies that favor a particular kind of economic activity will result in more resources being devoted to that activity, but this is usually a reallocation of existing resources rather than any overall increase. At least in the short run, targeted tax subsidies are likely to have about the same effect on overall economic activity as a general tax cut of the same size. Just as with a general tax cut, some taxpayers or sectors of the economy will be better off, but others will be worse off.

Some tax subsidies may serve to offset or compensate for other distortions in the economy, so that the reallocation of resources they represent may leave the economy better off in the long run. Accelerated depreciation and the investment tax credit, for example, may help to compensate for the overtaxation of corporate income that many economists believe results from the corporate income tax and the failure to adjust business depreciation allowances for inflation. Using one set of distortions to offset another, however, may require a greater understanding of how the economy works than now exists. Moreover, the kind of precise guiding of taxpayer behavior that, in theory, is necessary can be difficult to accomplish. It is hard to predict in advance how taxpayers will react to a specific provision, and to design and administer provisions that will assure those effects. Tax-exempt bond financing of industrial pollution control, for example, may well be encouraging "end of the pipe" control devices when more efficient control of pollution emissions could be achieved by basic changes in manufacturing processes or the treatment of raw materials. The residential energy conservation tax credit may simply have driven up the cost of home insulation and other energy-saving devices by the amount of the credit, while adding little to the incentive for energy conservation already provided by higher energy prices.

Whatever the merits of incentive-type tax subsidies, they represent an attempt by the federal government to induce taxpayers to do things they would not otherwise do in exchange for a tax saving. When compared to the alternative of a federal spending or regulatory program, this means of influencing behavior may appear less intrusive. But compared to a more general tax cut, it represents greater federal involvement in taxpayer decisions, and less reliance on market forces. With general tax cuts, taxpayers receive the tax savings automatically, and they can use them as they wish. With tax expenditures, the tax savings go only to those in specified circumstances, or who act in specified ways.

## Marginal Tax Rates

Tax expenditures can be viewed as both a cause and an effect of high marginal tax rates. Because tax expenditures remove a large share of income from the tax base, tax rates must be higher on the income that is left to raise the same amount of revenue. And because marginal tax rates are so high, there is continual pressure for tax expenditures that can shield income from those high rates.

Effective marginal tax rates have increased substantially overall in recent years, even though there has been no legislated increase in tax rates. In 1969, fewer than 6 percent of all tax returns had income taxed at marginal rates of more than 30 percent. By 1979, more than 14 percent of returns had income taxed at rates above that level. The share of total personal income taxed at above 30 percent rose from less than 6 percent in 1969 to more than 8 percent in 1979.<sup>2</sup>

Most of this increase occurred because inflation and real growth in incomes pushed more and more income into the higher tax brackets. This "bracket creep" could have been offset by reductions in marginal tax rates, widening of rate brackets, or some combination, but it was not. Only one of the tax cuts in the 1970s involved any change in rates, and that one, in 1978, offset only one year's bracket creep. At the same time, an increasing share of personal income was being excluded from the tax base. The percentage of personal income excluded from adjusted gross income by law or regulation rose from 13.5 percent in 1969 to 18.6 percent in 1979. Income tax credits offset 1.5 percent of personal income in 1979, up from 0.5 percent in 1969.<sup>3</sup> Taxes were also reduced by increases in the personal exemption and the standard deduction, which are considered part of the normal tax structure rather than tax expenditures.

The emphasis in the 1970s on narrowing the tax base by increasing deductions, exclusions, exemptions, and credits rather than cutting tax rates reflected in part a desire to concentrate more of the tax savings on those with low and moderate incomes.

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2. Eugene Steuerle and Michael Hartzmark, "Individual Income Taxation 1947-79," OTA Paper 48 (April 1981), Office of Tax Analysis, Department of the Treasury, Table A-5, p. 36.

3. Ibid., Table 1, p. 8 and Table 2, p. 14.

Increases in personal exemptions and the standard deduction, for example, provide greater tax savings to lower-income taxpayers than do across-the-board rate cuts. Many tax expenditures, however, especially those that take the form of deductions or exclusions rather than credits, provide substantial tax savings to higher-income taxpayers. The expansion of tax expenditures during the 1970s thus extended significant tax relief to higher-income taxpayers as well, even though there were no reductions in rates until 1978.

It is clear that tax expenditures can serve to reduce the burden of high marginal tax rates on taxpayers. A number of tax expenditures are frequently combined into "tax shelters" for wealthy investors. The oil depletion allowance, the deduction for intangible oil and gas drilling expenses, accelerated depreciation allowances, the investment tax credit, and the lower rates on capital gains are examples. These tax shelters enable oil drillers, real estate developers, manufacturers, and others to obtain the investment funds they need by, in effect, selling the tax savings to high-bracket taxpayers.

While this serves to ease the burden of high marginal rates on many taxpayers, this method can create significant "transaction costs" and economic inefficiencies. Reducing marginal tax rates directly, as the Congress has now done, can eliminate some of these inefficiencies in the investment process, channeling more resources into productive investment. This is especially true with respect to the top 70 percent marginal rate on investment income, which has induced many investors to seek tax shelters.

There is thus a fairly direct trade-off between rate reductions and tax expenditures. The more rates are reduced, the less is the incentive to use tax expenditures to ease the burden of high rates. But the more tax expenditures erode the income tax base, the higher rates must be on the income that remains to be taxed.

#### TAX SUBSIDIES AND DIRECT EXPENDITURE SUBSIDIES

Tax subsidies can also serve as alternatives to spending or loan programs. Almost any feature that is included in a spending or loan program can be duplicated in a tax subsidy. Providing tax subsidies in the form of credits rather than deductions, and including the credit in taxable income, can assure that the value of the tax subsidy is the same as that of an equivalent direct

grant. Making the credit refundable, as discussed below, can extend the subsidy to nontaxpayers, both individuals and businesses. Providing the subsidy in the form of a deferral of tax liability makes it the equivalent of a loan program. While no interest is normally charged on tax deferrals, it could be if the Congress wished. These are all questions of program design; the Congress can make tax subsidies look and work as much or as little like direct spending and loan programs as it chooses.

There are some practical differences between tax and direct expenditure subsidies, however, that may lead the Congress to choose one rather than the other. It can be difficult to extend tax subsidies to individuals and businesses that do not pay taxes; tax subsidies come under the jurisdiction of different committees than spending programs; they are subject to less precise control in the budget process; administrative control and review tends to be less detailed; and the beneficiaries of tax subsidies may prefer to receive subsidies in that form. Depending on the goals being sought, these can be viewed as either advantages or disadvantages.

#### Nontaxpayers

While it is possible to extend the benefits of tax subsidies to nontaxpayers, it can be cumbersome to do so. The most direct way is to provide the subsidy in the form of a refundable tax credit. This is a credit against taxes due that is paid directly in cash, or refunded, if the recipient does not owe enough taxes to use up the credit. The only refundable tax expenditure now in the law is the earned income credit paid to low-income workers with dependents, but it has frequently been suggested that the investment tax credit and other credits be made refundable as well.

Making tax credits refundable would be consistent with the underlying rationale for most such provisions, which is to provide a subsidy to the recipient. Since eligibility for nontax subsidies does not depend on whether or not the recipient has taxable income, subsidies provided through the tax code, proponents argue, should not be subject to this kind of limitation either. In addition, making tax credits refundable would eliminate the need for the current complex rules that specify the order in which credits must be taken, and provide for the carryback and carryforward of unused credits.

A number of objections have been raised to making credits refundable, including the extra cost, the administrative burden on

the IRS, and the impropriety of "bailing out" money-losing businesses. But the underlying concern on the part of many tax policymakers appears to be that making more and more credits refundable could eventually result in a large share of federal spending programs being run through the tax system, diverting the Treasury and the IRS from their traditional revenue-raising tasks.

In the case of most businesses, refundable credits would present few administrative problems. The records needed are readily available, and the beneficiaries are easy to identify and keep track of.

Nontaxpaying individuals, especially those with low incomes, are more difficult to deal with through the tax system. People whose incomes are so low they do not have to pay taxes usually do not have to file tax returns, so the IRS may have no record of their existence. It is thus hard to inform them of their possible eligibility for a subsidy. Once they learn about the subsidy, they may have difficulty with the forms and paperwork necessary to establish their eligibility, and the IRS has relatively few resources to provide them with assistance. Many low-income nontaxpayers also have considerable fear and skepticism about dealing with the IRS, and may thus be reluctant to apply for an IRS-administered subsidy. It may also be a hardship for them to have to wait until tax returns can be filed to obtain the subsidy. While attempts have been made to have the earned income tax credit reflected currently in withholding, there have been administrative problems with this approach. In the case of subsidies for low-income individuals, therefore, it may be preferable to provide the subsidy in the form of a direct grant administered by an agency with more experience in dealing with low-income people.

There are also some less direct ways of extending the benefits of tax subsidies to those who have little or no taxable income. Tax credits and deductions can be carried back to offset tax liability from earlier years, or carried forward to offset possible future liability. The present value to the beneficiary of any tax saving is reduced, however, if it is not actually received until some year in the future.

Leasing arrangements are another possibility. A business with low tax liability can lease its equipment from a bank or other firm with enough tax liability to take advantage of the investment tax credit and other tax subsidies, and obtain at least part of the benefit of the subsidy in the form of reduced lease payments. The



Economic Recovery Tax Act of 1981 eased very significantly the tax rules that apply to leasing, clearing the way for a substantial expansion in this activity. Even with these more liberal rules, however, there can be transaction costs and economic inefficiencies associated with leasing that can make this a less than ideal solution.

Another way of circumventing the nonrefundability of present business tax credits is through acquisitions and mergers. Firms with large accumulations of unused tax credits are frequently attractive candidates for mergers with firms with large tax liabilities. How the benefits of the tax credits are then divided depends on the terms of the arrangement between the companies involved.

#### Committee Jurisdictions

Tax subsidies come under the jurisdiction of the House Committee on Ways and Means and the Senate Committee on Finance. The rules of both Houses permit legislation to be referred jointly to two or more committees, so that it is possible for other committees to consider tax subsidies as well. The Rules of the House of Representatives specifically provide for a degree of joint responsibility:

Each standing committee of the House shall have the function of reviewing and studying on a continuing basis the impact or probable impact of tax policies affecting subjects within its jurisdiction . . . .<sup>4</sup>

But legislative jurisdiction lies with the tax-writing committees.

Proponents of a new program may prefer to cast it in the form of a tax subsidy in order to have it considered by the tax committees. This is especially likely if a proponent happens to be a member of one of those committees. More generally, however, the tax committees may simply be viewed as a more sympathetic forum, or the committees that would have jurisdiction over a direct spending subsidy may be hostile to the proposal or subject to budgetary constraints. Those proposing the subsidy may also not want to have

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4. Rules of the House of Representatives, Rule X(2)(d).

it administered by the executive agency that would be in charge of the program if it took the form of a direct grant.

Specialization and Expertise. It is often argued that it is inappropriate to have housing, health, education, employment, energy, agriculture, and other subsidies legislated by the tax committees, since they lack expertise in those specialized subject areas. The Mortgage Subsidy Bond Tax Act of 1980, for example, which placed limits on the use of tax-exempt bonds to finance single-family housing, required the tax committees to deal with many issues that were more familiar to the committees with jurisdiction over housing. But the tax committees have substantial experience in dealing with a number of direct spending programs. They have jurisdiction over major health and welfare programs, unemployment compensation, and Social Security, and have dealt extensively in recent years with energy issues. To the extent that the tax committees lack experience or expertise in a specific area, it may be possible through the process of joint referral to have tax subsidy proposals reviewed by the committees that have this expertise.

#### Budgetary Control

Budget Act Requirements. The Budget Act requires that five-year projections of the estimated levels of tax expenditures by major budget functional category be included each year in the Budget Committee reports accompanying the First Concurrent Resolution on the Budget. In addition, committee reports on all bills providing for new or increased tax expenditures must include five-year estimates of the revenue loss from those provisions. Beyond that, however, there are no direct controls over tax expenditures in the budget process. The budget resolutions themselves do not set targets for tax expenditures by budget functional categories, as they do for direct spending programs. Nor are the tax committees allocated target ceilings for tax expenditures, as all committees are in the case of spending programs under their jurisdiction.

Revenue Floors. Nonetheless, the budget process does impose one very important constraint on tax expenditures. Once the overall revenue floor is established by the second concurrent resolution, any legislation with a revenue loss that would reduce total revenues below the floor is subject to a point of order. This of course applies to all revenue-reducing legislation, not just legislation that provides special-purpose tax subsidies in the

form of tax expenditures. But the revenue floor sets up a "zero-sum game" in which all revenue-reducing bills must compete for the limited amount of tax reduction permitted by the budget resolution. If the budget resolution contemplates a tax cut of \$20 billion, for example, the cut may take the form of a broad, across-the-board rate cut, a series of special-purpose tax subsidies, or some combination, but the total tax cut cannot exceed \$20 billion. Elimination or reduction of existing tax expenditures would, of course, create room for additional general tax cuts. Across-the-board cuts that provide relatively modest tax relief to large numbers of taxpayers must therefore compete with tax subsidies that provide larger per-taxpayer savings to fewer taxpayers. While this kind of limit on the total amount of revenue-reducing legislation that the Congress may approve does not limit tax expenditures directly, it does create a situation in which they are likely to be subject to closer scrutiny.

The control over tax expenditures that results from the overall revenue floor is actually similar in many respects to the control over direct spending that is imposed by overall spending ceilings. While the second budget resolution does include limits on spending by major functional category, spending legislation is not subject to a point of order if it would breach those function-by-function ceilings. It is only the overall spending totals that are binding, just as it is only the overall revenue floor that limits tax expenditures or other tax cuts. The more detailed breakdown of spending categories may help to highlight potential breaches of the spending ceiling as bills move through the legislative process, but it is only the last spending bill that gets caught by the spending ceiling, just as it is only the last revenue-reducing bill that gets caught when the revenue floor is reached.

Reconciliation. Another budgetary control tool is the process called reconciliation, under which changes in spending and revenues can be ordered to reconcile current law spending and revenue levels with the overall totals agreed upon in the budget resolution. Reconciliation was first used in 1980 and resulted in fiscal year 1981 deficit reductions of approximately \$8.2 billion, \$4.6 billion from reduced outlays and \$3.6 billion from additional revenues. Most of the additional fiscal year 1981 revenues came from a "cash management" speed-up of tax collections, but substantial future-year revenues were projected from the phase-out of tax-free mortgage subsidy bonds.

Reconciliation was greatly expanded in 1981. Fiscal year 1982 outlay reductions from reconciliation are estimated at \$35 billion. Unlike 1980, however, reconciliation in 1981 did not include any revenue measures.

Nonetheless, as the 1980 experience demonstrates, reconciliation can be used to increase revenues as well as to reduce outlays. It cannot require changes in specific tax expenditures, however, just as it cannot require specific changes in spending programs. The decision on how to raise revenues is left to the tax committees. The revenue increases can come from across-the-board tax increases, increased user charges and excise taxes, reductions in tax expenditures, or other tightening and reform measures.

Visibility. It is often argued that tax subsidies have less visibility in the legislative and budget process than do direct spending programs, and that they are, therefore, subject to less regular and detailed scrutiny. This was certainly true in the past, but it has become somewhat less so in recent years. The tax expenditure budget, which lists all tax expenditures and the estimated revenue losses associated with them, is published each year along with the President's budget in January. It includes revenue loss estimates for the upcoming fiscal year and the two prior years. Two or three months later, five-year projections of estimated tax expenditure revenue losses are published by the Joint Committee on Taxation for the two Congressional tax-writing committees. These five-year projections of all tax expenditures are then included in the Budget Committee reports on the first concurrent resolution, and published separately by the CBO (see Appendix Table A-1).

Each bill increasing or reducing tax expenditures is accompanied by a report giving an estimate of the five-year loss or gain from the change, just as spending bills are accompanied by five-year cost estimates. Changes in tax expenditures have the same effect on the federal deficit as do any other tax or spending changes, and thus receive whatever attention and scrutiny that entails.

One problem with tax expenditures is that their cost in lost revenues can increase sharply and unexpectedly if economic or demographic conditions should change, since they are, in effect, "entitlement" programs that are automatically available to whoever meets the statutory eligibility requirements. Like Social Security, Medicare, and other entitlement spending programs, there

is no overall limit on the costs of the program. While it is usually possible to make reasonably good estimates of future costs, there are cases in which higher costs can occur with little warning. The use of tax-exempt bonds to finance single-family housing grew rapidly in late 1978 and early 1979, for example, threatening multibillion dollar annual revenue losses until the Congress stepped in to impose limits.<sup>5</sup> Tax-exempt industrial revenue bonds have been used to a much greater extent than previously available data suggested, since most of the bonds are not reported beyond the state level, if at all.<sup>6</sup>

Like entitlement spending programs, therefore, the future costs of tax expenditures are not as visible and predictable as those of programs with statutory ceilings. The early signs of cost increases can be especially difficult to detect with tax expenditures, since total tax collections may fall below expectations for a whole host of reasons. It is usually not possible to tie a decline in revenues directly to increased use of a particular tax expenditure, whereas it becomes quickly apparent when spending for a particular entitlement spending program increases.

Periodic Review. Tax subsidies are not regularly reviewed in the way that spending programs subject to annual appropriations or periodic reauthorization are. Most spending programs are not subject to detailed full-scale review on a regular basis, however, while many tax subsidies receive review when major tax cut legislation is being considered or as a result of scheduled expiration dates.

With the growth in recent years in entitlement programs and programs with long-term contractual obligations, a steadily declining share of federal spending is subject to the annual appropriations process. In fiscal year 1982, only about 50 percent of federal spending will be subject to discretionary annual appropriations, compared to 56 percent ten years ago. Even those programs that are subject to annual appropriations may not receive detailed scrutiny every year, since the usual issue is whether a program should get a little bit more or a little bit less, not whether it

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5. Congressional Budget Office, Tax-Exempt Bonds for Single-Family Housing (April 1979).
  6. Congressional Budget Office, Small Issue Industrial Revenue Bonds, (April 1981).

should exist at all. The same is true of spending programs that must be reauthorized every two or three years. Reauthorization requirements do not guarantee full-scale reexamination of programs and the need for them.

Five major tax cut bills were passed by the Congress in 1969, 1971, 1975, 1976, and 1978. Each provided the occasion for a review of existing tax subsidies, and four of them--the bills passed in 1969, 1975, 1976, and 1978--cut back or eliminated some significant tax subsidies. Each bill also created a number of new tax subsidies. Significantly, however, many of these new subsidies had scheduled expiration dates in order to give the Congress the opportunity to evaluate them after a few years of experience. Many also required that studies of the effectiveness of the new provisions be submitted to the Congress in advance of the expiration dates. Table 4 contains a listing of tax subsidies enacted since 1969 that included expiration dates and/or study requirements.

Setting an expiration date and requiring a study does not, of course, guarantee that the tax subsidy will be carefully reviewed before it is reauthorized, any more than similar requirements guarantee careful review of spending programs. But it does suggest that tax subsidies may become more like direct spending programs in the degree of periodic review that they receive.

#### Administration

Eligibility Rules. The ease of administration of any subsidy program depends mainly on the eligibility rules and how they are enforced. If eligibility depends on a few clear and simple rules, if the information needed to verify eligibility is readily available, and if no significant exercise of judgment is required to apply the rules, administration is relatively easy. But as the eligibility rules become more detailed and complicated, as the information needed to verify eligibility becomes harder to get, and as more individualized judgments become necessary, subsidies become more and more difficult to administer.

Administration of Tax Subsidies. Tax subsidies are not different from other subsidies in this respect. Tax subsidies do have some possible administrative advantages, however. First, a well-run bureaucracy to administer the subsidy already exists--the Internal Revenue Service. The IRS deals on an annual basis with nearly 100 million taxpayers. It has information on where they live, what their income is, how many dependents they have, whether

TABLE 4. NEW TAX EXPENDITURES WITH EXPIRATION DATES AND/OR STUDY REQUIREMENTS ENACTED BETWEEN 1969 AND 1981

New Tax Expenditure	Originally Scheduled Expiration Date and/or Study Requirement
Tax Reform Act of 1969	
5-year amortization of low-income rental housing rehabilitation expenses	December 31, 1974
5-year amortization of pollution control facilities	December 31, 1974
5-year amortization of railroad rolling stock	December 31, 1974
5-year amortization of coal mine safety equipment	December 31, 1974
Revenue Act of 1971	
5-year amortization of on-the-job training and child care facilities	December 31, 1976
Domestic International Sales Corporations (DISC)	Annual Treasury Department reports required on "operation and effect" of DISC system of taxation.
Tax Reduction Act of 1975	
Employee Stock Ownership Plan (ESOP) investment tax credit	December 31, 1976
New home purchase tax credit	December 31, 1976
Tax Reform Act of 1976	
Deduction for eliminating architectural and transportation barriers for the handicapped	December 31, 1979
Tax incentives for historic preservation	June 1981

(Continued)

TABLE 4. (Continued)

New Tax Expenditure	Originally Scheduled Expiration Date and/or Study Requirement
Tax Reform Act of 1976 (continued)	
Exclusion for group prepaid legal services	December 31, 1981; Treas- ury and Labor Department study required by Decem- ber 31, 1980.
Possessions Corporation Tax Credit	Annual Treasury Department reports required on "oper- ation and effect".
Tax Reduction and Simplifi- cation Act of 1977	
New jobs tax credit	December 31, 1978
Revenue Act of 1978	
Exclusion for employer educational assistance programs	December 31, 1983
Targeted jobs tax credit	December 31, 1981; Treas- ury and Labor Department report required by June 30, 1981.
Energy Tax Act of 1978	
Home insulation tax credit	December 31, 1985
Solar energy tax credit	December 31, 1985
Business alternative energy investment tax credits	December 31, 1982
Exclusion for employer-pro- vided transportation	December 31, 1985
Investment credit for commuter vans	December 31, 1985

(Continued)



TABLE 4. (Continued)

New Tax Expenditure	Originally Scheduled Expiration Date and/or Study Requirement
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Crude Oil Windfall Profit Tax Act of 1980	
Alternative fuel production credit	December 31, 2000
Alcohol fuel tax credit	December 31, 1992; annual Energy Department reports required through 1992
Credit for ocean thermal energy conversion equip- ment	December 31, 1985.
Credit for small-scale hydro- electric facilities	December 31, 1985
Credit for cogeneration equipment	December 31, 1982
Credit for intercity buses	December 31, 1985
Tax-exempt bonds for small- scale hydroelectric facili- ties	December 31, 1985
\$200/400 interest and divi- dend exclusion	December 31, 1982
Economic Recovery Tax Act of 1981	
Charitable contribution deduction for nonitemizers	December 31, 1986
Tax credit for research and experimentation	December 31, 1985
Tax-exempt savings certi- ficates	December 31, 1982
Tax-exempt bonds for pur- chase of mass transit equipment	December 31, 1984

SOURCES: Committee reports on each act.